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TAGS: ECON EFIN EINV CH HK
SUBJECT: CHINA BANKS GIVEN LIMITED CHANNEL TO INVEST IN FOREIGN EQUITIES

SUMMARY

¶1. (SBU) New rules allow banks with Qualified Domestic Institutional Investor (QDII) quotas to invest in equities in addition to fixed-income instruments, which are already permitted. Hong Kong registered funds will for now be the sole beneficiaries, since no other overseas regulatory body has yet signed an MOU with the Chinese Banking Regulatory Commission (CBRC) covering QDII supervision. A Hong Kong banker sees the change as valuable and of interest to clients but does not expect a significant change in outflows until the QDII quotas are expanded significantly and until foreign stock market performance becomes more attractive relative to the rapid appreciation underway among stocks traded on the mainland.
END SUMMARY

NEW POLICY

¶2. (SBU) The Chinese language May 10 China Banking Regulatory Commission's (CBRC) policy circular broadening the scope of overseas investment for commercial banks possessing a QDII license allows banks to invest their quotas in equities, not just fixed-income instruments. The circular states specifically that QDII investors are not allowed to invest in commodities, derivatives, hedge funds, or securities with a rating of less than BBB. Commercial banks are allowed to invest in overseas stocks according to the following constraints:

o The stocks purchased are listed on overseas stock exchanges;
o Up to 50 percent of existing QDII quota can be invested in overseas equity markets; only up to 5 percent of the QDII quota can be invested in one individual stock;
o A client of the commercial bank is required to invest a minimum of RMB 300,000 (around $40,000) in QDII products;
o The client should have experience in stock investment;
o Managers of overseas investment should be approved by or accredited to overseas regulators (e.g., the SEC) which have signed an MOU with CBRC on cooperation in QDII supervision;
o Investment is limited to those stock markets whose regulators have signed an MOU with CBRC on cooperation in QDII supervision.

LIMITED OUTFLOWS FOR NOW

¶3. (SBU) At present, only the Securities and Futures Commission of

Hong Kong has signed an MOU with the CBRC, so any QDII investments will have to be made through funds registered in Hong Kong. (Hong Kong's Hang Seng Index rose 2.5 percent Monday based on the news.)

¶4. (SBU) The China Securities Journal, summing up discussions with local financial experts, suggested the CBRC circular should help cool the heated Chinese stock market and reduce both RMB appreciation pressure and excess liquidity. However, the requirement that a client must invest at least RMB 300,000 (around $40,000) and the relatively unattractive anticipated returns when compared with the growth in the local A-share market have together caused some experts to predict that the circular will have a limited impact on China's A-share market.

HONG KONG: FIRST MOVER ADVANTAGE

¶5. (SBU) Hang Seng Bank Deputy General Manager Andrew Fung, who is in charge of that Hong Kong-based bank's QDII operations, told us during a May 16 visit to Beijing that the new rule is a "gift to Hong Kong." In his view, the current QDII quota of USD 14 billion remains largely unused because of anticipated RMB appreciation, high relative returns in Chinese equity markets, and existing restrictions on QDII investment funds managed by banks. The circular has two purposes: 1) to provide more investment choices for mainland investors currently focusing on irrationally overpriced domestic stocks, and 2) to encourage Chinese investors to buy more foreign exchange to reduce the growth of forex reserves.

¶6. (SBU) According to Fung, Hang Seng Bank will be allowed to invest half of its USD 300 million QDII quota in funds that are managed in Hong Kong. He expects initial client focus will be on the H-share market (HKD-denominated shares of Chinese companies issued and

traded in Hong Kong). Hang Seng will, however, have access under the MOU to 2,000 managed funds that are already registered with Hong Kong's Securities and Futures Commission. Fung predicted that products based on investing QDII quotas in these funds will be introduced first because equity funds on the Hong Kong Stock Exchange already have authorization and prepared prospectuses, making them easy to market. Since the equity funds available tap into markets around the world, the QDII funds can be easily diverted to stock markets beyond Hong Kong if future customers wish to focus beyond H-shares, said Fung.

¶7. (SBU) In line with other media commentary, Fung does not expect the QDII change to have any significant short-term effect on outward capital flows. However, if QDII quotas are raised over time and the relative performance of mainland markets declines, there could be a significant demand for the new products, in Fung's view.

COMMENT

¶8. (SBU) The new rules potentially open up opportunities for American and other foreign fund managers. They also appear to be part of a three-pronged approach to addressing rapidly rising stock prices through encouraging outflows, moral suasion, and increasing the supply of local shares by pushing for new IPOs to be conducted on the mainland. Still unaddressed, however, are low bank deposit rates, which remain negative in risk-adjusted terms.

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